Testimony of Donald R. Meyer, Commissioner, Department of Financial Institutions

Before the Senate Committee on Banking, Commerce & International Trade

Informational Hearing on the Effects of the Energy Crisis on Financial Institutions

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Mister Chairman, Committee Members, I am Donald Meyer, Commissioner of the Department of Financial Institutions.

Since the Federal Deposit Insurance Corporation ("FDIC") and the Department of Financial Institutions ("Department") share many of the same views and conclusions with regard to the energy crisis and its effects on financial institutions, I will be restricting my comments to issues not addressed by Mr. Masa or that amplify the Department's views as to the effects of the energy crisis on Department licensees.

The impact of energy-related risks on California's economy, and, in turn, on the licensees regulated by the Department is uncertain, yet potentially significant. While databases used by state and federal financial institution regulatory agencies, derived through quarterly reports developed by the Federal Financial Institutions Examination Council, do not contain loan or investment categories specific to energy, as Mr. Masa from the FDIC has indicated, the FDIC has surveyed California state-chartered banks as to the amount of loans, loan commitments, and investments in major California utility companies that are held in these financial institutions. The results of the FDIC survey revealed minimal amounts of direct exposure. The Department conducted a similar survey and found minimal risk, which was centered in equity investments and not loans. Our findings confirm that borrowings by such major energy producers remain with the very large nationally-chartered financial institutions who have the capacity of extending very large credit lines.

However, to enable the Department to assess and understand the potential impact of energy issues on the state's licensed financial institutions, the Department has sent out a questionnaire to its licensees to determine the extent of energy-related risks that go beyond the exposure to Southern California Edison and Pacific Gas & Electric.

The Department of Financial Institutions' survey seeks information, not only on direct loans to the large power producers, but also information on loans extended to the smaller energy producers in this state who may be selling to the major producers. We have also requested from the financial institutions information on loans to suppliers or service providers who are under contract with the power producers. For each of these categories, we have asked for the number of borrowing entities, total credit available to the entities, current outstanding balances, and any delinquency status of the borrowers. We have also asked the licensees to indicate any industry, business, or agricultural segment where power interruptions may significantly affect their production and profitability, thereby creating a credit problem for the financial institution and/or a viability problem for the business.

Preliminary response to the expanded survey confirms that Department licensees' greatest exposure is to businesses that have significant energy needs. The survey responses by the financial institutions indicate that their greatest exposures are to manufacturers where power interruptions inhibit production, and coupled with increased energy costs, are reducing cash flows and earnings. Businesses affected by energy issues, as noted by the Department’s licensees, include manufacturers, laundromats, lumber mills, tree service companies with contracts with large energy producers, flower growers with greenhouses, and delta farmers who face increased energy costs to pump out the Delta islands. Financial institutions indicate that, at this time, the risk is manageable. However, several institutions expressed concern about fixed income customers. Another licensee has expressed concern that if a major employer in their service area cannot survive consistent outages or energy cost increases, employees will be affected and the problems and potential losses will affect their entire portfolio – mortgages, vehicle loans, etc.

We would like to note that many of the financial institutions responding to the survey have taken a pro-active approach to the energy situation by identifying borrowers that have significant risk due to power interruptions and have contacted these borrowers to determine what risk mitigation procedures the borrowers have enacted. One licensee has stratified its loan portfolio into a three-tiered energy risk matrix with the highest direct risk allocated to manufacturers, an indirect high risk rating to borrowers with high fixed operating costs and moderate risk allocated to borrowers with low fixed energy operating costs. This pro-active approach by these institutions will enable them to better manage the energy risks in their loan portfolio.

Potential credit problems in financial institutions are also mitigated by lending limits that restrict a financial institution’s exposure to any one borrower. In addition, financial institutions are required to establish guidelines for portfolio diversification and for managing concentrations of credit. These guidelines are required to address management’s plans for monitoring and taking prompt, appropriate action when problems arise. The lending policy also establishes acceptable parameters which limit the portfolio by loan type; volume, such as a percentage of equity, or loans, or deposits; growth rates; risk grade, etc.

Finally, the Department has issued an Examination Guidance Memorandum to all examination staff to review energy-related risks and review an institution’s risk management policies and procedures so that the institutions can effectively identify any emerging energy-related problems for the institution and its customers in a timely fashion. The Department also requires that the adequacy of the financial institution’s efforts to identify and manage energy-related risks are to be commented upon in each Report of Examination, and any material deficiencies/exposures in this area are to be discussed with the Assistant Deputy.

Mister Chairman and Committee Members, this concludes my presentation and I am prepared to respond to any questions that you may have.